

Moscow Financial Weekly

For the week ending April 25, 2003
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Cabinet agrees on tax reform
- CBR management speaks out at ARB conference

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/\$ (MICEX) UTS	R31.0984	-0.30	-2.16
Monetary Base*	R982.1 bln	1.55%	4.45**
CPI	NA	NA	5.2
International Reserves*	\$57.7 bln	3.23	20.96
RTS Index (end of week)	430.39	6.84	12.19%
Refinancing rate	18	0	-3

*For week prior

** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

The pieces of the government's fiscal policy for the short and medium term are beginning to fit together, with Cabinet agreement on the parameters of a **tax reform package**, announced on April 23, and a **medium-term fiscal program** for 2003-2005 approved on April 29. These decisions will aid in formulation the 2004 budget, which is scheduled for review by the government on June 5. The tax cut is essentially backloaded, as the government compromise features a reduction in VAT from 20 to 18% and abolishment of the sales tax in 2004. The VAT tax cut is compensated by a reduction in government expenditures equal to 1% of GDP, and a small increase in taxes on the natural resource sector. A reduction in the social tax from 35.6% to 26%, which would pack more punch, both in terms of revenues to government coffers and savings to firms, would be enacted in 2005. VAT would be unified at 16% in 2006. If implemented, the plan would result in a reduction equivalent to 2.5% of GDP for the next three years. The medium-term fiscal program strives for government surpluses of 0.6% of GDP in 2004 and 0.9% in 2005, based on an average oil price of \$22/bbl in 2004 and \$22.50/bbl in 2005, with all budget surpluses above \$20/bbl going into the proposed stabilization fund.

According to MEDT, the economy achieved **productivity growth** of 6.0% in the first quarter of 2003, following a decline in 2002 of 1.2%. The industrial sector showed a significant increase of 11.4% in the first quarter, giving a further boost to companies'

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bottom lines, in addition to higher oil prices during this time. Increased productivity mainly reflects reform in the oil industry. There is much room for improvement in other sectors of the economy, which would strengthen firm's overall competitiveness and reduce costs stemming from real appreciation of the ruble against the dollar.

Goskomstat has confirmed the preliminary **2002 GDP data** released in March, leaving the figure unchanged: GDP totaled R10.86 trillion in nominal terms and increased by 4.3% in 2002. At the same time, the Ministry of Economy revised its 2003 forecasts and estimates that GDP will grow by 5% in 2003. The increase is based on favorable macroeconomic indicators released for the first quarter of this year: according to Prime Minister Kasyanov, GDP growth totaled 6.4% during that period.

Banking sector

On April 23, the 14th annual **Congress of the Association of Russian Banks** took place in Moscow, having been preceded by ARB's conference on banking liberalization and legislation. In his speech to the conference, CBR First Deputy Chairman Andrey Kozlov focused on two pieces of legislation currently in the Duma: the deposit insurance bill and the bank bankruptcy bill. He said that the Duma considers these bills "not as technocratic, but rather as political" and they are held up for these reasons. The deposit insurance bill will pass a first reading on April 25, Kozlov told the conference, and would be adopted in the fall. (However, the first reading has been again rescheduled, this time for May 14). CBR Chairman Sergey Ignatiev told the congress that about 20 banks from Russia's top 100 are involved in unfair commercial activities, but the CBR has no legal grounds to revoke their licenses. Instead, Ignatiev promised not to admit these banks into deposit insurance system. He said that in 2002 Russian banks sent abroad about \$5 billion under contracts for "marketing" services. There may be two explanations to this fact, the CBR Chairman believes: either it was money laundering or capital flight. Ignatiev also said that average profitability in the banking sector in 2002 was 18%. Sberbank was the leader with 21%. Meanwhile, eight banks from the top 100 report profitability below 3% over the past few years. There may be three reasons for that, according to Ignatiev: poor management (not likely, since these banks are rapidly increasing their capital); inflated capital that cannot generate profit; or underreporting of profits. Ignatiev refused to name these banks, but according to the Interfax rating agency, six banks from the top 100 showed profitability under 3% in 2001-02: Alfa Bank, Mezhprombank, MDM Bank, Guta Bank, Globex and Sobinbank (the latter showed less than 0.5%).

On April 22, the CBR posted on its web-site draft regulations governing accession of banks to the **deposit insurance** system. The criteria are divided into 4 groups: (1) a CBR assessment of each bank's financial stability; (2) transparency of ownership structure; (3) quality of operational management, risk management and internal controls; and (4) strategic management and business planning. To pass the test and be admitted to the system, banks will need to get enough "points", as defined by the CBR, for each group of criteria. Despite the fact that the CBR elaborated complex algorithms for calculating these points in the appendices, banks are complaining about the subjectivity of the regulations.

CBR Chairman Sergey Ignatyev said that the **real effective ruble rate** strengthened in January-April by 3-3.5%. According to Ignatyev, the ruble has firmed 2.1% against the dollar in nominal terms and weakened against the euro 1.7%, while inflation in Q1 was 5.6%. Meanwhile, the Ministry of Economic Development and Trade forecasts an 8.4% real appreciation of the ruble against the dollar in 2003.

On April 21, the **Duma Committee on Credit Organizations and Financial Markets** recommended passage (in the second reading) of amendments to the bank bankruptcy law proposed by Duma Deputies and the Supreme Court of Arbitration. (The GOR had announced earlier that it would be preparing a separate set of amendments, but these have not yet been submitted to the Duma: they may eventually be dropped in favor of the Duma/Arbitration Court version already under consideration.) According to the recommended amendments, the CBR will have the authority to convene a board meeting of the bank in distress to decide its financial rehabilitation, if it considers such a step to be necessary. In case a bank goes bankrupt due to the fault of founders or management, the court may place subsidiary responsibility on them. A bank whose license is revoked should meet current obligations within the expenditure estimates approved by the CBR. When a bank challenges the CBR's decision to revoke its license, it will not suspend the bankruptcy court proceedings, and even a court ruling invalidating the license revocation would not reverse the bankruptcy process.

On April 25 the Duma passed, in all three readings at once, an amendment to the Tax Code regarding **taxation of interest income**. Until now, interest on bank deposits in excess of 75% of the current refinancing rate was subject to income tax. Many banks spoke out against this clause, Sberbank most vociferously, especially since the CBR cut the refinancing rate to 18% on February 17, 2003. According to the new amendment, only interest exceeding the full refinancing rate will be subject to income tax.

On April 24, a shareholders meeting of the **MICEX** voted to dismiss Aleksandr Zakharov, who had headed the exchange for the last ten years, and appoint Aleksandr Potemkin as General Director. The CBR is biggest MICEX shareholder, with 28% ownership. Potemkin was the founder of the first currency exchange in the Soviet Union, and before the 1998 financial crisis was CBR Deputy Chairman in charge of exchange rate policy. The CBR also replaced Deputy Chairman Oleg Mozhayskov with another CBR Deputy Chairman, Konstantin Korischenko, as MICEX Board Chairman.

Rosbank plans to issue a \$100-150 million Eurobond later this year or early next, according to Aleksandr Popov, Chairman of the Board. Rosbank is the bridge bank to Uneximbank, which defaulted on a \$250 million Eurobond following the 1998 financial crisis.

Bank Zenit also plans to issue a \$100-150 million Eurobond in mid-2003. Zenit also said it would soon place (at the MICEX) an issuance of ruble-denominated coupon-bearing 3-year bonds worth R1 billion at par value.

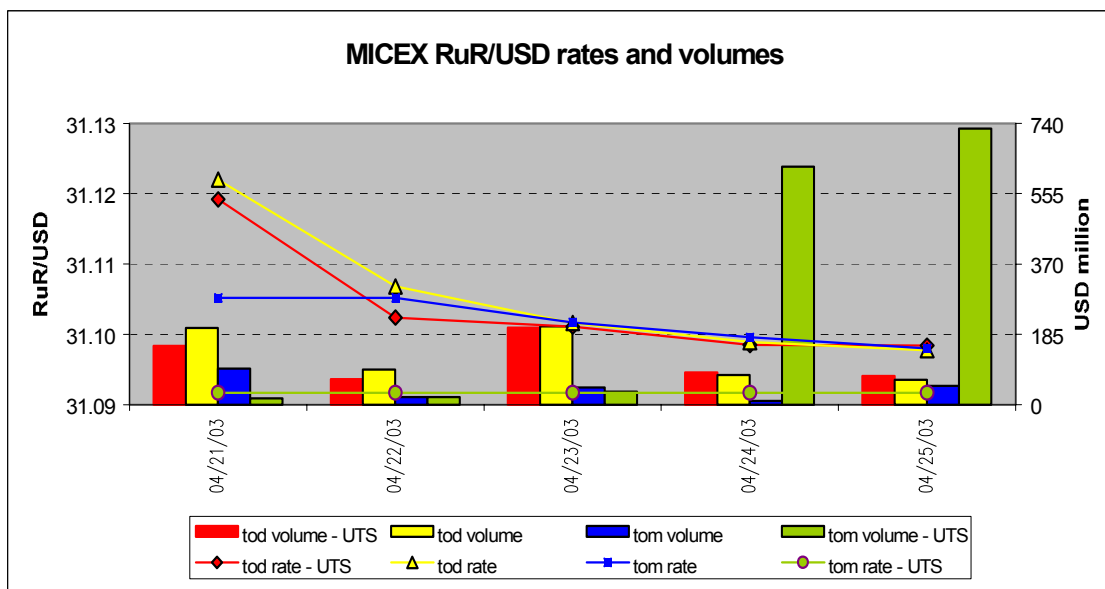
Financial markets

Forex Market

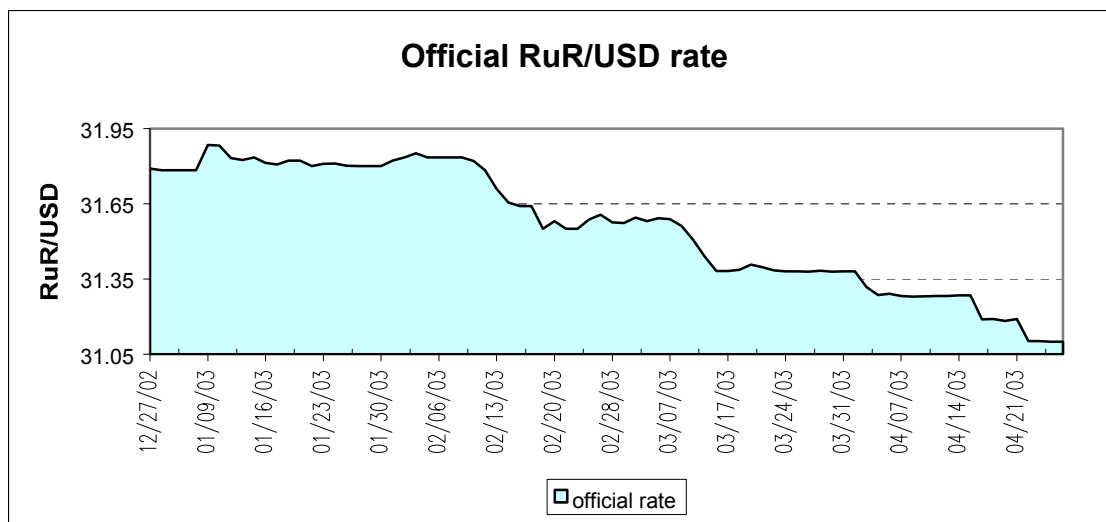
As during the week ending April 18, the main changes in the ruble/dollar rate occurred at the very beginning of the period observed. On April 21, the CBR shifted its bid down to R31.10/\$, thus setting a new benchmark for the market. During the rest of the week the dollar continued to weaken against the ruble, but at a very slow pace, remaining in the close vicinity of the "benchmark" set by the CBR. Only in the UTS "tom" trading, which is now used to determine the official rate, did it settle at precisely R31.10/\$.

Interestingly, but not surprisingly, the trading volumes increased dramatically, since the CBR decided to "fix" for a while the official rate. The situation with ruble liquidity (a sort of squeeze happened by the week's end) still has no impact on exchange rate dynamics, as the supply of dollars far exceeds the market demand and the CBR remains virtually the sole buyer.

For the week, the dollar weakened 0.30%, closing in the UTS on April 25 at R31.0984/\$. MICEX weekly trade volumes were \$585.36 million and \$1423.33 million, \$644.01 million and \$218.86 million for the morning (UTS) "tod" and "tom" sessions, and afternoon "tod" and "tom" sessions, respectively.

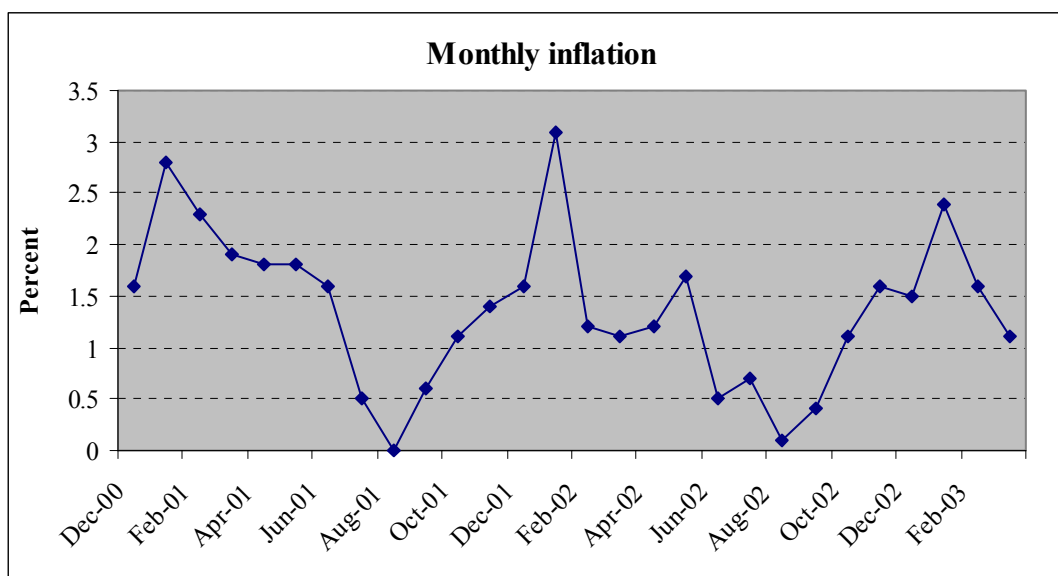


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Prices

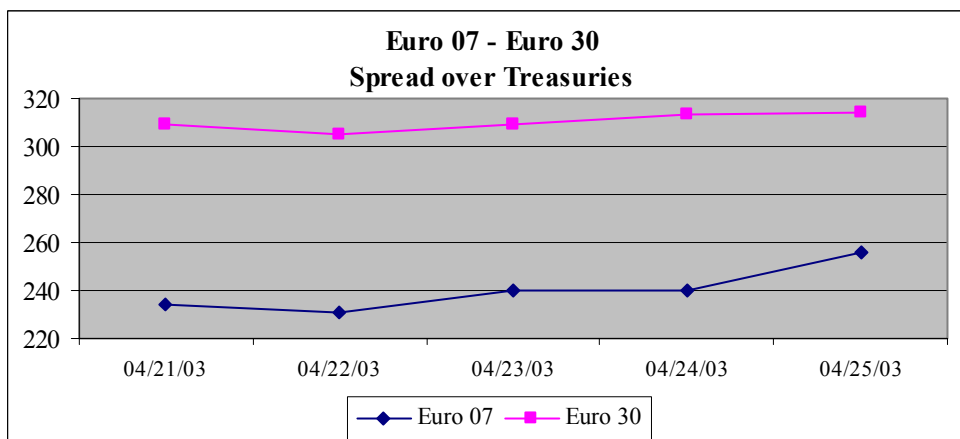
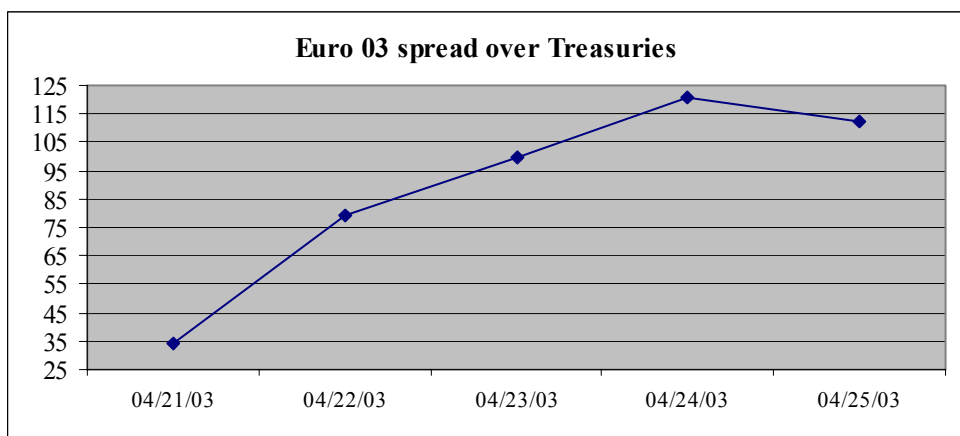
N/A



Eurobonds

Russian Eurobonds were fluctuating around the record high levels reached the week before. The Euro-30 price was able to reach 88 1/2 par last week. The relative well-being of the Russian sector was paralleled by turmoil in the overall emerging-markets debt market.

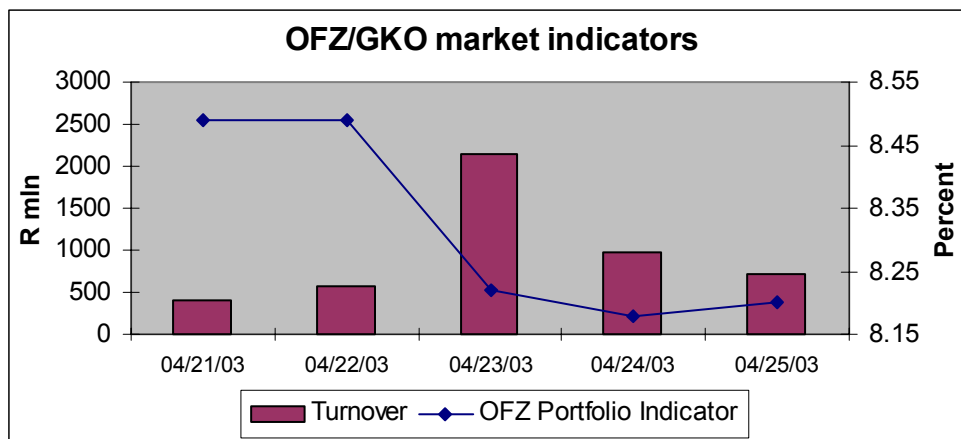
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Interest/Bond Market

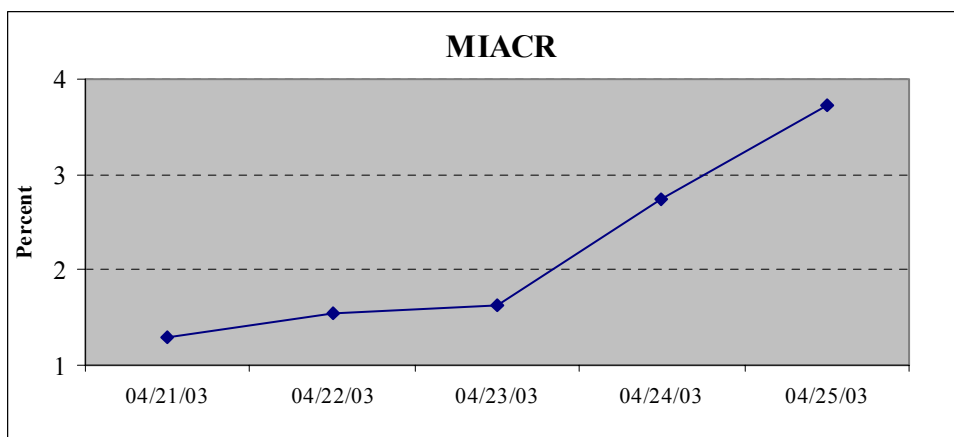
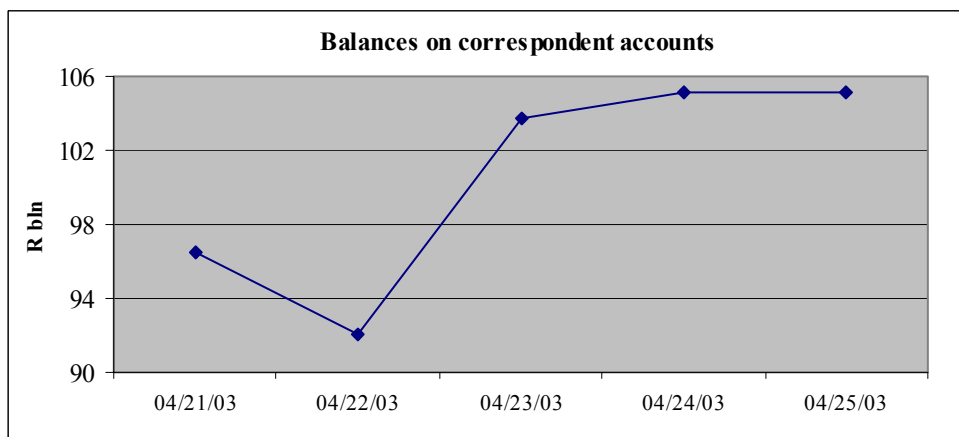
Bonds/Bills

The secondary OFZ/GKO market continued to grow last week. The main factors that were supporting the market before remained the same: increased ruble liquidity and ruble appreciation. The rubles that could not buy OFZs at the primary auction on Wednesday entered the market elsewhere, giving the additional stimuli for the price growth. The yields for the longest issues remained below 9% p.a. last week.



Overnight rates

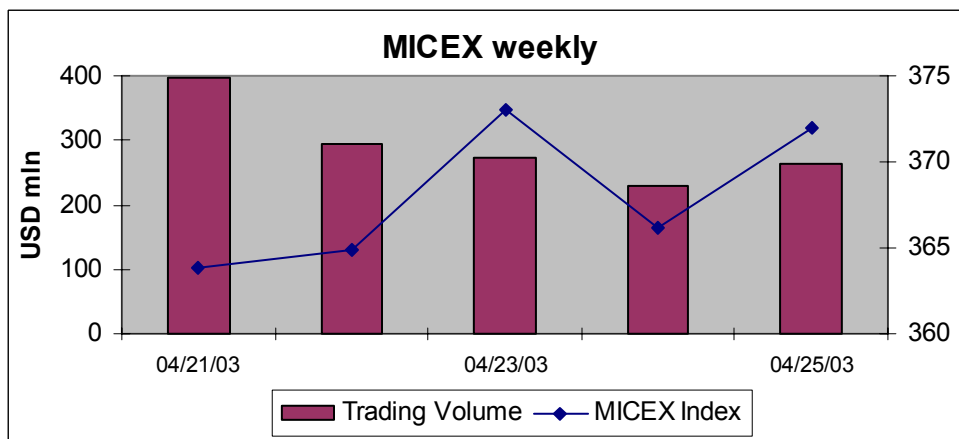
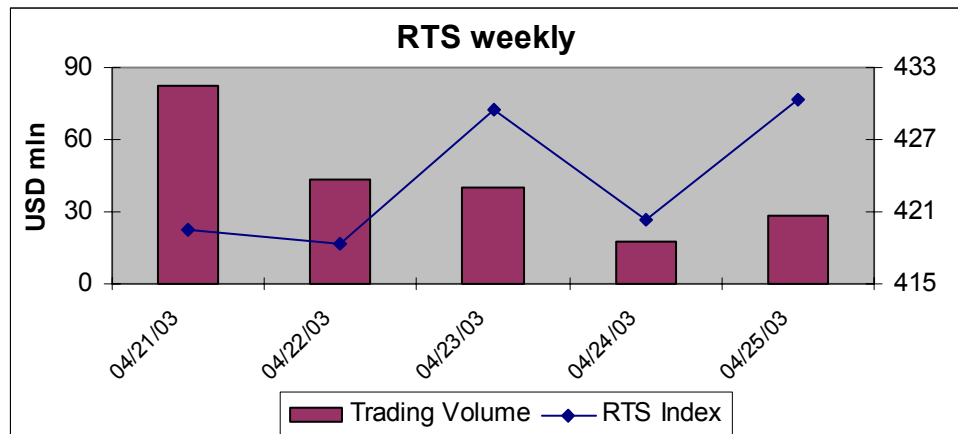
The balances on banks' correspondent accounts remained high last week, with average daily balances up at R100.5 billion. By the end of the week, the rates on the short ruble interbank market increased to 5% p.a. for the first time since March. The reason might be increased client payment orders ahead of the upcoming Russian holidays (May 1-2 and May 9, with many Russians taking the intervening week off.)



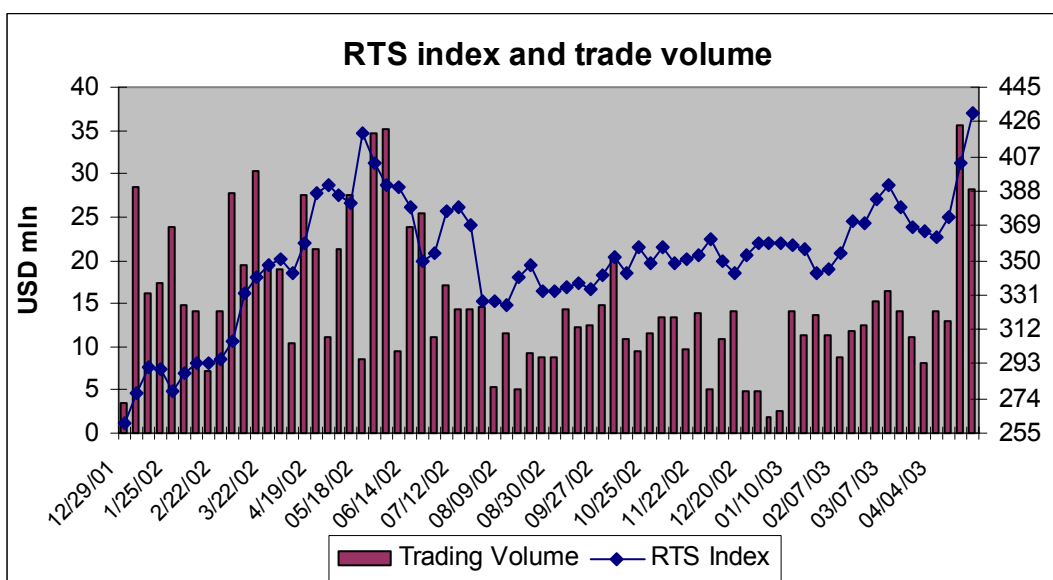
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Stock Market

The RTS index continued to rise last week, piercing through the highest level of last year, which was around 425 points. The index started up considerably on Monday. Surgut shares especially were in demand that day: the event feeding this demand, which increased the market capitalization of the company by 19%, was the likely consolidation of shares by the company's management in fear of a hostile takeover. Trading volumes increased substantially through the middle of the week, while during the downward correction on Thursday due to falling oil prices, volumes were down, indicating the bullish attitude of market players. Surgut, Sberbank and Mosenergo shares were in the most demand by the end of the week. For the week, the RTS index was able to climb up by 6.84%, stopping slightly above the 430 level, which is the highest in five and a half years. The last time the index was that high was on November 6, 1997, when it reached 438.34.



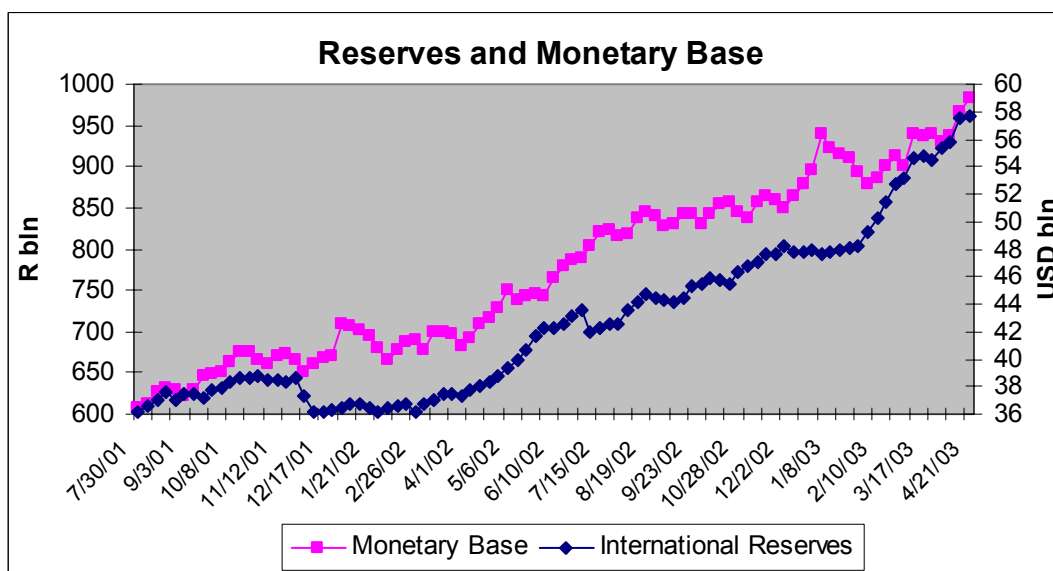
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International Reserves and Monetary Base

The CBR's international reserves were up for the week ending April 18, but growth was more modest than has been the case over the past few months, showing an increase by a "mere" \$100 million, which brings reserves to another record high of \$57.7 billion.

The monetary base increased again and reached the record level of R982.1 billion, 1.55% higher than a week before.



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EXPLANATORY NOTES

1. EXCHANGE RATES: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS "tom" weighted average becomes the "official" exchange rate for the next day. "\$-tod" price is the price of the dollar with same day delivery. "\$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is \$100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. LOMBARD CREDITS, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.

